

§ 1.636-2

26 CFR Ch. I (4-1-03 Edition)

gain realized on a transfer of a mineral property to which section 636(b) applies may be returned on the installment method under section 453.

[T.D. 7261, 38 FR 5463, Mar. 1, 1973]

§ 1.636-2 Production payments retained in leasing transactions.

(a) *Treatment by lessee.* In the case of a production payment (as defined in paragraph (a) of § 1.636-3) which is retained by the lessor in a leasing transaction (including a sublease or the exercise of an option to acquire a lease or sublease), the lessee (or his successors in interest) shall treat the retained production payment for purposes of subtitle A of the Code as if it were a bonus granted by the lessee to the lessor payable in installments. Accordingly, the lessee shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income for the taxable year so applied. The lessee shall capitalize each payment (including any interest and any amounts added on to the production payment other than amounts for which the lessee would be liable in the absence of the production payment) paid or incurred with respect to such production payment. See paragraph (c)(5)(ii) of § 1.613-2 for rules relating to computation of percentage depletion with respect to a mineral property burdened by a production payment treated as a bonus under section 636(c) and this section.

(b) *Treatment by lessor.* The lessor who retains a production payment in a leasing transaction (or his successors in interest) shall treat the production payment without regard to the provisions of section 636 and § 1.636-1. Thus, the production payment will be treated as an economic interest in the mineral in place in the hands of the lessor (or his successors in interest) and the receipts in discharge of the production payment will constitute ordinary income subject to depletion.

(c) *Example.* The provisions of this section may be illustrated by the following example:

Example. In 1971, A leases a mineral property to B reserving a one-eighth royalty and a production payment (as defined in § 1.636-

3(a)) with a principal amount of \$300,000 plus an amount equivalent to interest. In 1972, B pays to A \$60,000 with respect to the principal amount of the production payment plus \$16,350 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1972 and subsequent years will include (subject to proper adjustment under section 1016) the \$76,350 paid to A. In 1973, B pays to A \$60,000 with respect to the principal amount of the production payment plus \$12,750 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1973 and subsequent years will include (subject to proper adjustment under section 1016) the \$72,750 paid to A. The \$76,350 received by A in 1972, and the \$72,750 received by A in 1973, will constitute ordinary income subject to depletion in the hands of A in the years of receipt of such amounts by A.

[T.D. 7261, 38 FR 5465, Mar. 1, 1973]

§ 1.636-3 Definitions.

For purposes of section 636 and the regulations thereunder:

(a) *Production payment.* (1) The term *production payment* means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in such mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term *production payment* includes payments which are commonly referred to as *in-*